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VIENNA PLEASE PASS TO CODEL SMITH

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SUBJECT: ITALY SCENESETTER FOR CODEL SMITH

REF: STATE 163079

¶1. Embassy Rome warmly welcomes the visit of Codel Smith.
Please find below background information to serve as a
scenesetter for visit.

Summary: A Traditionally Strong Bilateral Relationship

¶2. U.S. - Italy relations traditionally have been strong regardless of the party in power. The return of center-left leader Romano Prodi as Prime Minister has not significantly changed the substance of our bilateral relationship, despite the new government's well-known opposition to the war in Iraq. Early predictions that Prodi's government was unstable and would fall quickly now appear alarmist, though Prodi faces a difficult challenge this fall as he must pass a tight budget hitting political allies and the opposition alike in order to meet EU budget constraints. The Prodi Government has taken a strong international role in resolving the Lebanon crisis, first by hosting an international peace conference on the conflict and later by committing to send up to 3,000 troops to an enhanced UNIFIL force. The Italians will assume operation command of UNIFIL in February 2007. On the economic front Italy pledged 30 million euros for Lebanon at the Stockholm donors conference. In Iraq, PM Prodi has announced plans to withdraw all Italian troops by the end of ¶2006. However, the Prodi government pledged \$30 million for civilian reconstruction efforts and the development of a democratic and stable Iraqi government, and the Italian administration supports increased NATO police training. Italy remains one of our top security partners, hosting about 17,000 U.S. military personnel at Italian bases. On Iran, Italian officials have told us consistently that Italy will support a sanctions regime passed by the UN even though sanctions would significantly affect Italy's bottom line - Italy is Iran's second largest trading partner in the EU.

Prodi Stands Despite Early Predictions

¶3. Prodi leads a diverse coalition of allies ranging from centrist oriented Catholic parties to radical communists. During the election campaign, the center-left coalition was often plagued by internal disputes, with the radical-left assuming an increasingly high-profile role. Radical left parties scored significant gains, winning roughly 12 percent of the vote and capturing 38 of the potential 158 center-left seats in the Senate, making them essential to the Prodi government. Prodi has been able to hold his coalition together and to pass controversial legislation supporting Italy's military commitments to Afghanistan. After years in the political wilderness, fear of losing power has proven

strong glue for the center left.

Significant Economic Handicaps and a Budget Battle

¶4. High public debt and consistent budget deficits, rising social welfare costs, persistent unemployment, and a stagnant economy all limit Italy's financial ability to increase or sustain Italy's overseas missions. The current budget has reduced foreign assistance by 27 percent and defense spending by ten percent (to about 0.90 percent of GDP), well below the NATO 20 percent benchmark. Peacekeeping funding, carried as a separate line item outside the budget, was cut by 20 percent for 2006. These economic handicaps and EU pressure have forced Prodi to introduce an austerity budget for 2007 that has heightened tensions within his coalition. The political battle to pass the budget will be the most important test of the strength of Prodi's government.

Taking a High-Profile Role on Lebanon

¶5. Despite public differences with the U.S. on Iraq, Italy has played a leading role in Lebanon. In July, at the request of the U.S., Italy hosted an international conference attended by Foreign Ministers from 20 nations and international organizations to discuss the international community's role in resolving the current crisis in Lebanon. The discussion focused on support for an international stabilization force, the need for an urgent and sustainable cease-fire, humanitarian concerns, and the reconstruction of Lebanon. Immediately after the conference, Italy pledged to contribute 3,000 soldiers to an enhanced UNIFIL.

Shift to Civilian Cooperation in Iraq and Afghanistan

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¶6. Italy, with approximately 1,600 troops located in the British sector, is the third largest troop contributor in Iraq after the U.S. and UK. Before the April elections, the Berlusconi government announced a timetable for the gradual drawdown of Italian troops with the aim of repatriating most by year end and transforming the mission into a primarily civilian one. Prodi, in an effort to distinguish his government's policies from those of the previous government, and citing an electoral mandate for complete troop withdrawal, has announced he will withdraw all troops by the end of 2006.

¶7. Nevertheless, Italy will continue its reconstruction efforts and has pledged to strengthen political, civilian, and humanitarian cooperation and support for the Iraqi government, including training of security forces under the NATO umbrella. Many of these efforts will be coordinated through the recently launched Iraq Compact.

¶8. Italy is among the most active members of the ISAF mission in Afghanistan maintaining an average of 2,000 troops in Kabul and Herat, where Italy commands the western sector of the country. However, pressure from the far left will keep the government resistant to greater engagement in combat operations, particularly in the south. Refunding the Afghan mission will be a political challenge for the Prodi government again in December.

Seeking a Broader Role in World Affairs

¶9. Italy is a member of the EU, NATO, G8, and will soon rotate onto the UN Security Council. The GOI under Prodi has sought to play a role in many international crises and hopes its leadership in Lebanon will help give it a seat at the table on other important global issues. In his recent visit to Lebanon, Prodi reiterated his government's belief that the key to long-term stability in the region is finding an equitable solution to the Israel - Palestinian conflict, as solution that is guaranteed by the international community.

The Italians would like to help make that happen.

Including a Role in Iran

¶10. Despite not being a member of the core group of nations seeking to resolve the current impasse over Iranian nuclear ambitions, Italy has told us repeatedly that it wants to be consulted on Iran policy, and that they are grateful that we have included them in consultations.

¶11. Total two-way trade between Italy and Iran reached 5.17 billion euros in 2005, making Italy Iran's second biggest trade partner in the EU. According to the Italian statistical agency, ISTAT, Italian exports to Iran are dominated by machinery, manufactured goods, and chemicals, while imports are overwhelmingly comprised of oil and related products. Italian companies have an active presence in many sectors of the Iranian economy but are concentrated in the petroleum sector.

¶12. Italy had at least 433.2 million euros in foreign direct investment in Iran as of December 31, 2004. That figure is likely understated because it does not take into account foreign direct investment through foreign subsidiaries or through service contracts, whereby a firm can invest in, for example, the oil sector, but only by relinquishing the title to the infrastructure the firm builds in return for the promise of a return through downstream oil flow proceeds. For example, ENI, Italy's oil and gas parastatal, reports it has invested 2.5 billion euros over a period of several decades.

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